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economic LETTER

JUNE 2011

AUTO INDUSTRY BACK ON THE ROAD TO GROWTH

The automotive industry is the most important manufacturing industry in Canada. It accounts for about 10% of production and creates demand in many other sectors, including steel, rubber and plastics. It provides 109,000 direct jobs in vehicle and parts production, each of which generates many other jobs in related sectors, such as the aftermarket business and automobile dealerships, which employ another 330,000 people.

After many years of prosperity, the Canadian automotive industry went through a tough time during the last recession. Production was 28.5% lower in 2009 than 2008 because of the collapse in demand from the United States, to which Canada exports about 80% of its production. Two of the "Big Three" North American auto manufacturers–General Motors and Chrysler–were close to bankruptcy and only avoided it because of bailouts from the Canadian and U.S. governments, which allowed them to restructure. Since then, the industry has recovered. According to the Canadian Vehicle Manufacturers Association, production jumped 41.2% in 2010 over the previous year. Interestingly, much of this growth came from increased production at plants owned by GM and Chrysler, which have already repaid most of their government loans.

What is the growth outlook for the Canadian automotive industry? According to the Scotiabank Group's Global Auto Report, after strong sales growth in recent months, a temporary slowdown is to be expected in the short term. The shortage of parts caused by the Japanese earthquake and tsunami slowed production by Japanese manufacturers, which makes up 36% of total Canadian production. Despite this setback the outlook for 2011 is still positive: the recovery of the United States job market should generate increased revenues and renewed confidence that will induce Americans to replace their old vehicles. Americans have been hanging onto their vehicles longer because of the recession, and the average age of cars in the U.S. is now over ten years, which is a record. According to the Scotiabank Group's latest estimates issued in March, Canadian production should grow 9% in 2011.

Over the long term, a variety of factors will affect the industry, including the price of raw materials and especially oil, greenhouse gas emission regulations ▼

1 Industry Canada, Canadian Automotive Sector Overview 2010, 2009 data.
2 Scotiabank Group, Global Auto Report, May 10, 2011.

Canada
> **Real GDP growth picks up speed**
> **Job creation expands**
> **Housing starts and home sales decline**
> **Differing growth outlooks in the provinces**

United States
> **Job growth slows**
> **Housing sector still depressed**
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> **Consumer and business confidence both down**

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BDC's Monthly Economic Letter is produced by the Strategy and Corporate Development department and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to June 4. Reliance on and use of this information is the reader's responsibility.

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and changing consumer preferences, but it is very difficult to determine how they will impact on production. For example, the rise in gas prices has not yet had a negative effect on vehicle sales in Canada. In fact, according to the Canadian Automobile Dealers Association, it could even have a positive impact by inducing consumers to replace their vehicles with more energy-efficient models. Over the next decade, manufacturers could adjust by producing fewer large vehicles and more smaller ones, but technological advances could also allow them to produce more efficient vehicles without compromising too much on size. There are already sports utility vehicles that consume only half as much gas per kilometre as their predecessors, and it's safe to bet that the research will not stop there. ■

CANADA

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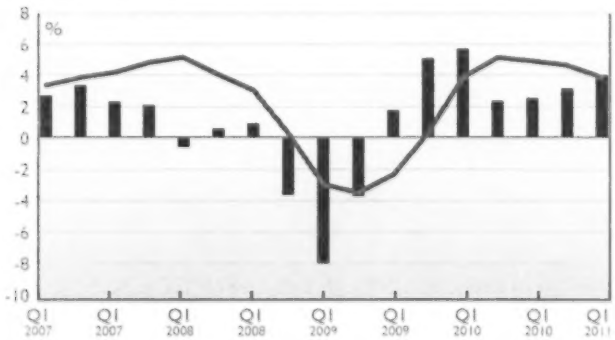
The pace of real GDP growth picked up again in the first quarter of the year, and labour market activity remains strong. Although forecasters expect growth to slow in 2011, the overall outlook remains positive. Greater demand for commodities will create regional disparities, however. Economic growth in the provinces that have abundant raw materials – especially oil – is likely to be higher than in the other provinces.

Economic growth picks up speed again

Real GDP growth picked up speed again, rising from 3.1% in the fourth quarter of 2010 to 3.9% in the first quarter of 2011 (see graph). The main causes of this healthy growth spurt in the first quarter were increased private investment – in both residential construction and non-residential investment – and a big jump in inventory. Consumer spending and government expenditures remained virtually unchanged from the previous quarter. In foreign trade, exports rose 6.4% while imports grew even more (10.4%), with the result that net exports cut into real GDP growth.

Real GDP Growth



Source: Statistics Canada

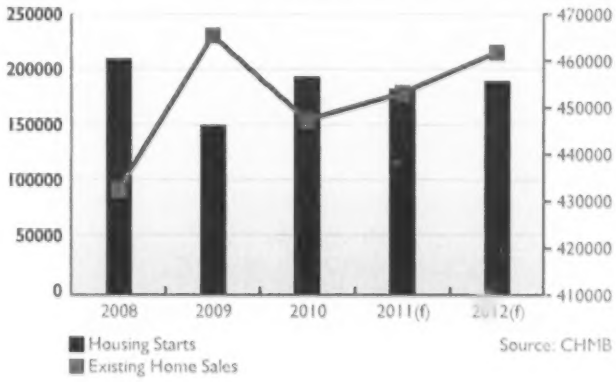
Job creation expands

After a small loss of 1,500 jobs in March, employment grew by 58,300 jobs in April and the unemployment rate dipped slightly to 7.6%. Ontario posted the biggest gains in April with 55,000 jobs. Much of the increase in employment was in part-time jobs (41,100) but with the addition of 17,200 jobs, full-time employment returned to the level it was at in October 2008 before the recession. Strong labour market activity should stimulate consumer spending in the second quarter.

Housing starts and existing home sales decline

Housing starts fell from 184,700 units in March to 179,000 units in April. Multiple-unit housing starts were down while single family home starts in urban areas were up. Sales of existing homes fell 4.4% in April from the previous month. Canada Mortgage and Housing Corporation has revised its housing start projections upward from 177,600 to 179,500 units for 2011. It also expects a small increase of 1.3% in sales of existing homes this year. The CMHC forecasts are based on mortgage rates remaining low and stable, a firming up of the job market and economic growth in general over the course of the year, and rising net migration. ▼

Housing Starts and Existing Home Sales

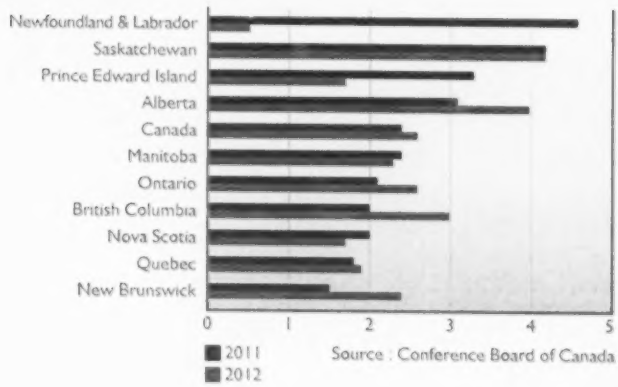


Source: CHMB

Differing growth outlooks in the provinces

According to the Conference Board's latest forecasts, after reaching 3.3% in 2010 economic growth in Canada should slow to 2.4% in 2011 and 2.6% in 2012. The end of the government's economic stimulus programs and high levels of household debt will dampen domestic demand. However, greater demand for commodities will create provincial differences. The outlook for the Western provinces and Newfoundland-Labrador is brighter than that for Ontario, Quebec and the Maritimes. ■

Real GDP Growth Forecasts, by province



Source : Conference Board of Canada

★ UNITED STATES

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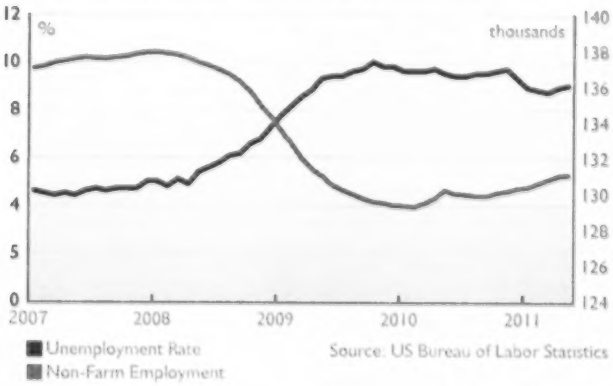
The job market is improving but at a snail's pace: employment is a long way from returning to normal levels and the unemployment rate remains high. In addition, the housing sector is having trouble emerging from the slump it has been in for the past few years. On top of that, rising oil prices are putting a brake on consumption and consumer and business confidence have both deteriorated. In short, based on the latest data, economic growth remains fragile in the United States.

Job growth slows

After three substantial consecutive monthly increases with average gains of 220,000 jobs, employment grew by only 54,000 jobs in May. The private sector added 83,000 jobs but the manufacturing sector lost 5,000, the first decline in more than 6 months. The unemployment rate edged up slightly from 9.0% in April to 9.1% in May. Improvements in the labour market situation are extremely slow: compared to pre-recession levels, employment remains very weak and the jobless rate high, as shown in the graph below.

Non-Farm Employment and Unemployment Rate



Source: US Bureau of Labor Statistics

Housing sector still depressed

After a 12.9% increase in March, housing starts were down 10.6% in April from the previous month. At the same time building permits, which were up 7.5% in March, fell 4.0% in April. Sales of existing homes followed the same trend, contracting by 0.8% in April after rising 3.5% in March. Also, according to the S&P/Case-Shiller Home Price Indices, prices of existing homes in 20 metropolitan areas declined for the ninth consecutive time in March, with the one-year change worsening from -3.4% to -3.6%. In short, the housing market is still struggling. After the collapse in this sector in recent years, credit conditions for buyers are still very tight, which is hampering the recovery. It is to be hoped that the labour market situation will improve so that the housing sector can recover.

Retail sales growth slows

Retail sales were up 0.5% in April following an increase of 0.9% in March, and were 7.6% higher than at the same month last year. Sales of motor vehicles and auto parts were 11.0% higher than in April 2010, pointing to the recovery in the automotive industry. On the other hand, sales of products that are usually stimulated by property purchases – such as furniture and household appliances – barely moved during the year, and sales of construction materials and gardening equipment and supplies, which are also linked to housing, actually declined. A decline in consumption is to be expected in the next few months if the price of gas remains high, since consumers will have less money to spend on other things. ▼

Consumer and business confidence both down

The Institute for Supply Management Purchasing Managers Index for the manufacturing sector, which reflects the level of confidence of companies in that sector, dropped significantly from 60.4% in April to 53.5% in May, mainly due to a decline in new orders and production. In addition, the Conference Board Consumer Confidence Index, which had risen slightly in April, plummeted again, from 66.0% in April to 60.8% in May. Rising gas prices and persistent problems in the housing market are the most likely reasons for the decline in consumer and business confidence. ■

INTEREST RATES

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Bank of Canada opens the door to an increase in its key interest rate

The Bank of Canada left its key interest rate unchanged once again on May 31, but in its press release it opens the door to an increase. The inflation rate exceeded the upper limit of the target range and is expected to remain high temporarily, but there is still a lot of surplus production in the economy, so the Bank does not fear rising inflation in the short term. However, if the economy continues to expand the central bank will have to step in to curb inflationary pressures over the longer term. According to the Consensus, a majority of forecasters expect the key interest rate to rise by 50 basis points by the end of September, followed by a further increase of 50 basis points in the last quarter, which would bring the year-end rate up to 2.0%. In the United States the key interest rate is not expected to rise this year. On the contrary, the Federal Reserve is continuing to inject liquidities into the system with the aim of bolstering the economic recovery, which is still fragile. ■

OIL AND THE LOONIE

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Price of oil and dollar both fall

After soaring in March and April because of disruptions in many Arab countries, the price of oil fell sharply in May, following the International Energy Agency's downward revision of forecast global oil demand. Paradoxically, the rise in oil prices was the reason for the revision: the Agency expects high oil prices to put a brake on consumer spending in industrialized countries, which will slow their growth. These fears were reinforced by the latest indicators showing that the economic outlook in the United States–one of the biggest oil consumers–is uncertain. Demand from emerging countries will remain strong, but not strong enough to offset the decline in demand from industrialized countries. The Canadian dollar was dragged down by the fall in the price of oil. ■

Crude Oil Price and Canada-U.S. Exchange Rate

Source: Global Insight

SME CONFIDENCE

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Optimism among small business owners falls sharply

The CFIB Business Barometer Index, which had remained high for the last five months, fell abruptly in May. It lost nearly 4 points compared to April, falling to 69.4, its lowest level since November 2010. Provincially, Ontario recorded the biggest decline in May but confidence was also down in five other Canadian provinces, especially those that suffered from severe weather and flooding (Quebec, Manitoba and Saskatchewan). Entrepreneurs in the wholesale, manufacturing and finance sectors are the most optimistic, while those operating in the accommodation sector remain the most pessimistic. Similar to the results in the past three months, hiring intentions remain positive, but firms are still concerned about rising fuel and energy costs. ■

CFIB Business Barometer and Real GDP Growth
(Index of 50 = equal balance of stronger and weaker business expectations)

■ Index, 0 - 100
■ GDP : % ch. Q/Q , a.r.

Source: Canadian Federation of Independant Business

BUSINESS CREDIT CONDITIONS

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Business credit from chartered banks still trending up

The upward trend in business credit from chartered banks continues. The annual rate of change, which was 2.8% in April, has clearly returned to positive territory after being negative for nearly two years. Short-term credit, which accounts for 87% of business credit from chartered banks, was 2.6% higher in April 2011 than April 2010, while the annual growth in long-term credit was 4.5% over the same period. ■

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest		Forecasts	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.9				Mar	0.3	2.9	2.7
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.4						11.5	8.3
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	22.1						14.3	8.4
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.6	7.4				Mar	1.1	4.4	3.9
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.1	8.7				Mar	0.9	4.2	2.8
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	11.8							
Housing Starts (' 000 units)	229	212	149	192	178				Apr	179	174	179
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	0.2						2.8	2.5
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6				Apr	0.3	2.7	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	2.4				Apr	0.3		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	7.8				Apr	7.6	7.6	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2				Apr	70.7		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	69.7				Apr	72.3		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.